K3 Advisory response to the DWP public consultation on the consolidation of defined benefit pension schemes.

Introduction

- K3 Advisory is the pension market's only specialist independent bulk annuity and consolidator advisory business. We specialise in helping trustees and/or sponsoring employers de-risk using insurance, i.e. buy-ins and buy-outs.

- We are very supportive of innovation in the industry and believe there is an important role consolidators could play in helping make sure UK defined benefit (DB) pension schemes can de-risk and hence protect member benefits.

- Further, the insurance buyout market is extremely busy with the amount of liabilities transferred to insurers in 2018 being of the order of £20bn. That figure is a drop in the ocean compared to the overall size of the DB universe, and the development of a well-run consolidator market could bring much needed capacity for schemes trying to de-risk and improve member security.

- Before commenting on some of the specific questions raised within the consultation we wanted to highlight some key areas we feel are important.

DB benefits are not guaranteed

- Perception must move away from DB pension benefits being viewed as guaranteed, they are not. The only 'guarantee' could be viewed to be the PPF level of benefits, which typically might be of the order of 60% of members full entitlements.

- "Expected scheme benefits" are the benefits of those schemes multiplied by the probability that the scheme can support paying those benefits in the long-term. The ability to support paying will depend on the combination of the funding position of the scheme and the employer's ability to make good any deficit.

- It has long appeared apparent to us that, for schemes where the expected scheme benefit is at the lower end of the spectrum, there is a large gap between the current security of members' benefits and those benefits being insured, with no middle ground. Hence, if those schemes can't afford buyout, which by definition they won't be able to, they currently have no option but to hope their employer remains solvent.

- The consolidator market could provide an in between option, but an important outcome of this consultation, and any future legislative changes, is to allow a solution to develop that is materially different to the security and cost of insurance, whilst still improving the expected scheme benefits.

- One of our major concerns with the current proposal is that superfunds will be only marginally lower risk than an insurer and, as a consequence, only marginally lower cost, so the schemes that may need this "middle ground" the most won't be able to access it.

- There are currently schemes exploring the cost of moving to a superfund and, at the same time, getting costs from insurers. Although information on those processes is limited we understand that in some cases insurer pricing is not too dissimilar to the superfunds. That may evidence that the two solutions are too close to provide a viable alternative for most schemes.

Small schemes

- DB pension schemes are complex which, in no small way, is a consequence of years of over regulation. For example, the current uncertainty and complexity around GMP equalisation is adding no value, in our view, to scheme members. What it is doing is wasting resource, time and making it harder for schemes to move forward to buyout and the safe haven that provides for members.

- A very worrying consequence of this complexity is that it exists in all schemes, whether large or small, and therefore, from an insurer perspective, they are much more likely to focus on larger schemes than smaller ones.

- It has become increasingly difficult for small schemes, who can afford to buyout, to do so. This is the case typically for schemes with liabilities below £20m and becomes very acute once you drop to liabilities below £10m, where there are examples of schemes being unable to get any insurance companies to give them a quotation.

- This is a big issue. Looking at the Purple Book published by the PPF in 2018, 36% of schemes in the UK have between 2 and 99 members, with an average asset size of just over £8m. Therefore, over a third of the DB schemes in the UK will struggle to insure their benefits, even if they can afford it. That is almost 2,000 small and medium size businesses that cannot shift the burden of a DB pension scheme from their balance sheet even if they have the means to do so.

- Schemes of this size are the ones who need consolidating more than any others, as the cost of running these schemes is disproportionately high. Now, the market does have lower cost options for such schemes, and we are aware that there are numerous commercial providers who aggregate such schemes so that they benefit from economies of scale and can run more cost effectively. But critically, in our view, those options don't in themselves necessarily improve member security, and they certainly do not allow the sponsor to exit the scheme, which is an option many want.

- A major concern, in general, with the developing consolidator market is it will develop into another market that small schemes have no access to. Consolidator business models almost certainly must be based on scale and, given the complexity of DB schemes, those consolidators, just like insurers, will tend to focus on larger schemes. We feel there is a very real danger that the outcome here will be that the consolidator market develops into another alternative for larger schemes (who need consolidation least) and bring no options for smaller schemes (who need consolidation most).

- We appreciate this is a very difficult issue. We have thought hard about whether insurers and consolidators alike could either be incentivised and/or subsidised in some way to make the economics of dealing with small schemes more advantageous, but we concluded that it is difficult to find a palatable way to do this.

- We believe the bold, and right move, would be to bring in legislation that allowed schemes who intend to either do a buyout with an insurer and/or moving to a superfund to be able to make scheme benefits much simpler. This would significantly reduce the complexity for everyone and make transacting significantly less work, and hence could lead to much needed capacity for small schemes.

- The other aspect to this, which we would like to see addressed in this consultation, is to make sure the regulation is proportionate. For small schemes there is a real danger that some of the advice trustees will be required to take could be disproportionately expensive and act as a barrier for them to move to a superfund.

- Lastly, on small schemes we encourage you to think carefully about whether they should be able to consider consolidators irrespective of their funding and employer covenant. If you conclude a small scheme, based on the approaches set out in this consultation, can afford buyout within say five years, then they cannot move to a superfund. If that scheme can't actually get an insurer to give them a quotation because they are so small what are they to do?

- The superfunds, particularly those who are targeting buying out the schemes with an insurer at some point, are potentially an excellent way to aggregate those schemes up so that they have the scale to then move across to the insurers in the future. We think this should be encouraged, and the process they need to go through to make this happen should be simple and proportionate.

Solvency Estimates

- A concern we have with some of the options outlined in this consultation, and we expand on this in our answers to your questions, is basing key metrics on whether a scheme can afford buyout on some specified basis or, say, the schemes solvency estimate.

- Our view is the industry struggles to predict and estimate insurer pricing.

- Additionally, it moves around materially over the course of the year for many factors, meaning knowing the position at one point does not mean that the position is the same at some other stage.

- In discussions with insurers we have heard of cases they have transacted where their premium was as much as 20% below the solvency estimate the scheme had. If the process for schemes entering superfunds is going to be fair to the insurance market and members, this situation must improve.

- For example, you could make it a requirement for schemes to at least see if they can get a quotation from insurers when considering whether to enter a superfund. Insurers themselves may be able to judge quickly whether they are likely to be able to price competitively for the scheme.

- Given the estimate of the cost of buyout could be used in various places in this regime, we think further work is needed to get a better and more consistent approach to estimating this number.

Consultation questions

- We have not answered every question posed but have focussed on questions where our expertise can add value.

Question 1 - Are these characteristics wide enough to define a superfund? If not, how could superfunds be defined for the purposes of a future regulatory regime?

- We can see situations where you might not sever the link to the sponsoring employer immediately and that would be attractive to the Sponsor, Trustees, Superfund and members.

- For example, could a well-funded scheme with a strong employer choose to use a Superfund that's aim is to buyout the scheme with an insurance company? By doing this the Sponsor might achieve buyout for its members at a lower cost. For the Trustees this would be difficult to allow as the Sponsor, given time, could afford the buyout cost. By maintaining the Sponsor link all parties might be able to affect a transaction that ultimately ends in buyout but more cost effectively.

- We note that this could create regulatory arbitrage or at least appear to so it would need to be carefully thought through, but as noted in our opening comments at the very least this sort of flexibility would be extremely helpful to smaller pension schemes.

Question 2: Given the differences of superfunds and traditional DB occupational pension schemes, what are the additional risks and challenges associated with TPR regulating superfunds?

- The premise of a superfund is to remove a covenant, whether that be weak or strong, and replace it with a capital buffer. Although clearly not identical this has similarities with insurance.

- Insurers are heavily regulated and must demonstrate their ability to understand and manage the risks to avoid a situation where the capital backing those risks would run out. It feels to us that a similar level of scrutiny is required on a superfund.

- Would TPR have the resource and skill sets to challenge superfunds on their modelling of risks? There is clearly a regulator, the PRA, that is highly skilled at regulating such business models.

Question 4: Are there any circumstances in which it would be advantageous, or necessary, that the authorisation criteria are not applied to the whole superfund but instead to individual segregated sections when the superfund scheme is sectionalised?

- The risk here may be more in superfunds that are not sectionalised. We believe there could be circumstances, regarding the ongoing monitoring of a superfund, that TPR would want to keep a watching brief on.

- Our experience from the insurance market is that the PRA requires active insurers to provide ongoing information on their pipeline and large cases.

- If a superfund is actively pursuing schemes that are very large, or large relative to the size of the superfund, then extra scrutiny appears sensible as a 'pricing' error on that trade not only risks the security of the members of that scheme but potentially the security of the overall superfund, particularly if the superfund is not sectionalised.

Question 5: Are these restrictions the right ones to ensure that superfund corporate structures are transparent and compatible with regulatory supervision? Are there any other measures that would aid TPR's ability to supervise superfunds?

- We believe it is important to make sure superfunds are incorporated and managed from the UK.

Question 7: Should TPR have a discretionary power to require evidence that individuals outside the superfund structure meet the fit and proper persons requirement?

- Yes. Where individuals outside the superfund corporate structure can exert influence over the superfund we believe it is important that TPR can get comfort about those individuals.

Question 9: Should TPR have the power to interview individuals for the purposes of the fit and proper persons test?

- We believe that would be sensible assuming TPR is appropriately resourced for that and has individuals with the expertise to provide challenge to the individuals they are interviewing.

Question 10: Are there other areas that should be included as part of the mandatory fit and proper persons requirement?

- We would suggest, for completeness, to include an individual whose responsibility is to be the money laundering officer. Also, given the actuarial nature of the business it is likely the superfund, outside of the scheme actuarial function, will employ an individual effectively as a "Chief Actuary". If that is the case, then we would suggest that person should also be subject to the checks.

Question 11: Would introducing a set of standards of conduct for the superfund's corporate board be proportionate?

- We agree that this would be a sensible approach and believe it would be proportionate.

Question 14: Should there be a minimum requirement on the proportion of independent NEDs on the superfund's corporate board or should this be left to TPR discretion? If so, what would be a suitable proportion

- We believe that this market will not benefit from a "one size fits all approach" and as such would suggest allowing TPR some level of discretion.

Question 15: Should superfund trustee boards consist entirely of independent trustees?

- We believe this is the right approach but critically that does not mean they have to be professional trustees.

Question 16: Should there be a non-affiliation requirement for the appointment of trustees to a superfund's trustee board?

- We believe non-affiliation to be a good idea. Trustees should be free from conflicts of interest and we also believe that TPR should be interested in how Trustees are remunerated for their role.

Question 21: Should superfund financial adequacy be regulated through a pensions based funding requirement approach with an added test of probability of success or an insurance based approach using a Solvency II type balance sheet?

- Given the similarities with insurance companies we feel an insurance based approach would be most appropriate.

Question 23: Does a 99% probability of paying or securing members' benefits over the lifetime of the scheme adequately protect members' benefits, and effectively balance the competing priorities of employer affordability and member security? If not, what would an appropriate probability be, and why?

- This is an area where care is needed. Some schemes currently, when taking account of employer covenant, may give members less than a 99% probability of paying or securing member benefits in full. For a minority of schemes the situation will be well below 99%.

- Insurers have to operate to a 99.5% level of having enough resources to meet liabilities and overall it feels like a 99% test would potentially preclude schemes that might need this solution the most.

- If, for example, a scheme was in a position that it had 80% chance of paying all members benefits, but with a Sponsor injection of cash could afford to move into a consolidator which gave a 90% chance of paying all member benefits then is that not desirable?

- Clearly a robust independent assessment of probability of paying all member benefits would be needed and you would not want to create a market where Sponsors can dump their schemes in the lowest cost consolidator. They would clearly have to be able to demonstrate that member outcomes had been improved.

Question 24: Should a superfund have a long-term objective to secure benefits with an insurance company?

- On balance we think not.

- Given the size of the DB market and the current levels of buyout activity this would probably constrain the market overall.

- But if a Trustee chooses a superfund that has no objective to buyout then clearly they are putting the members into an option where getting to the security of an insurance policy is no longer possible. It feels, for such superfunds, they ought to operate on a basis that gives members some upside given they can now no longer achieve an insurance security level.

- An example of this would be for the superfund to be required to provide additional benefits to members before, or at the same time, it takes funds out of the superfund structure to pay investors.

Question 25: Is the proposed authorisation basis suitable for this purpose? If not, what basis, if any, would you propose for this purpose?

- We believe that the basis for this exists already in the insurance regime. Insurers are required to calculate a best estimate liability and then set their capital appropriately for the risks they run. Why would a superfund not adopt such an approach, but clearly the probability of having enough resources would be set at a lower level, i.e. lower than a 99.5% scenario?

- The trouble with an authorisation basis that tries to mimic what is buyout pricing is that it is very difficult to set and is not something, in our view, the industry does well. The evidence we have seen suggests, for example, pension scheme solvency bases are generally higher than where insurance pricing trades.

- This can further be backed-up with an increasing trend in 2018 of schemes achieving a buyout with an insurer with a surplus amount of assets, i.e. they approach the market later than they could have and employers had contributed more than was necessary.

Question 26: Is a 97.5% probability of being 100% funded on an authorisation basis by the earlier of 2040 and the date the scheme reaches its estimated peak cash outflows consistent with the principle of a superfund having a 99% probability of paying or securing members' benefits at all times?

- We don't see the need for having such a target. Schemes should be buying a certain probability of members receiving all benefits upfront and not something less than that. A superfund should be managed to that level of certainty from the start.

Question 28: Are the additional minimum standards in (iii) needed, in order to ensure a high level of protection for member benefits? In particular, are the additional minimum standards (that the superfund scheme itself is funded to 87.5% on the authorisation basis) required for every scheme entering a superfund?

- There might be a danger that this precludes schemes from entering where it would be in the members interest to do so. Clearly, once the scheme is in the superfund it should have at least the same level of assets it had before being part of the superfund. The question for the Trustees is then one of whether they require additional funding within the scheme to ensure that members probability of receiving all benefits is higher now than before entering the superfund.

Question 29: Should superfunds be required to publish an annual balance sheet using market valuations and including liabilities valued on a buyout basis together with a buffer fund based on the Solvency II approach?

- Given a superfund's similarities to an insurance company we believe that greater transparency is needed, and an annual balance sheet is one way that could be achieved.

- There are various options for how that could be structured but we suggest requiring superfunds to state the best estimate of their liability (and the basis used for that) as well as holding capital at the level appropriate for the risks they run and the probability of paying all members benefits they are targeting.

Question 30: Should superfunds be required to secure benefits with an insurance company as soon as practicable, once the scheme assets reach the buyout level of liabilities?

- This might stifle innovation in the market and restrict capacity, both of which are not desirable.

- If you are going to do this then measures would have to be put in place to make superfunds target getting to buyout funding (which again is a hard thing to define without actually testing the market).

- For a superfund whose model is to run on the schemes, or where schemes are not segregated, it is surely unlikely they will ever be at buyout funding level because either:
    (a) The superfund is taking dividends for being ahead of its target, which works against the scheme getting to buyout funding; or
    (b) For non-segregated funds new schemes are being merged into the overall superfund at lower than buyout level meaning the overall fund is never likely to be fully funded to buyout.

Question 31: Should superfunds be required to maintain a minimum level of scheme funding regardless of approach to financial adequacy? This could include a separate long term objective for the superfund scheme itself to reach a buyout level of funding but to a lower level of probability than the superfund as a whole?

- If the premise of superfunds is that they are there for schemes that don't have a realistic chance of achieving buyout, then why impose an obligation on the superfunds to achieve that level of funding if it is more than is needed to give the probability of all member benefits being secured at the level they are targeting?

- The issue with doing so is it will push up the cost of getting into a superfund and make it potentially unattainable for the schemes whose members will benefit the most from it.

Question 33: What powers should TPR have to intervene should a funding level trigger be breached?

- The starting point should be similar to the powers the PRA has to intervene when insurance company solvency drops, for example restricting the ability to write new business.

- This feels a potentially big issue for superfunds that are segregated. For example, small pension schemes run material longevity concentration risk, i.e. typically most of the scheme's liability resides is a small proportion of the membership. Insurance buyout for such schemes is great value as they are receiving pricing based on the pooling of their mortality alongside all the insurer's other policyholders. If a segregated consolidator is not allowing the pooling of longevity risk across all segments, then it is a very real possibility that a funding trigger will happen on one of their small schemes at some point (purely through bad luck). If the activation of a funding trigger on one (potentially small) segment places consequences on the whole superfund then that might make such structures unattractive to run.

- We believe this is an important issue as you could see a situation where a sectionalised superfund has one section failing, and hence going into the PPF, due to bad mortality experience, whilst they may have profited on other small sections, again down to lack of pooling. This, in our view, should be avoided. One way to avoid it is to insist that superfunds pool mortality risk across schemes, similar to the way insurers currently do.

Questions 34 to 42

- In general, we agree that the proposed triggers would work. The triggers in all cases should be based on scheme assets plus a capital buffer.

- We believe it is fair to allow superfunds to extract profit once they are ahead of their authorisation funding level, however we agree this needs to be a reasonable margin ahead as, in many cases, there is no obligation on a superfund to put extra funding in if the level of funding falls below the authorisation level. It would not be desirable for a superfund to extract funds and then to fall below the authorisation level quickly and have no obligation to repay those funds.

Question 44: Should superfunds be restricted from taking profit until the funding level is above that required to secure a buyout?

- We agree that this has major positives for the alignment of interests but overall we feel this would restrict innovation and, potentially, capacity in the market.

Question 45: Is it reasonable to allow a sectionalised superfund to take profit or write new business if one or more sections are inadequately funded?

- We believe this will depend, amongst other factors, on whether the superfund is pooling longevity risk or not. It feels awkward for a superfund to drop schemes into the PPF due to adverse longevity experience whilst profiting from favourable experience elsewhere. This is a situation that is quite possible for sections containing small schemes.

Question 46

- We believe that the funding triggers would need to be assessed at a section level to protect the PPF from receiving schemes funded below a S179 basis.

Questions 47 to 49

- When a scheme chooses a superfund it should do so on the improved probability of members receiving all benefits. The superfund, as already stated, should be clear what probability of paying all benefits it is targeting. As part of that it will have a clear strategy for both the buffer and the scheme assets. We don't think that the superfund should be able to deviate away from those strategies because of changes in funding status, particularly a deterioration in funding.

- Currently Trustees have measures they can take to try to recover funds from a Sponsor in a stress event. We think it is desirable that they have a similar right to access the buffer in a stress event. If we could simplify the ability of superfunds to extract funds from schemes once they are funded above a certain level, then it would be plausible to force superfunds to transfer funds immediately on scheme funding dropping below prescribed limits.

Question 51: Should superfunds be required to submit their modelling for TPR to review, or should TPR develop a model against which they can assess all superfund proposals?

- This could be a similar approach to the insurance world where internal model approval is required, or they use the standard model approach.

- We think superfunds should submit their models for review but clearly this will require TPR to have the resource and skill set to assess those models.

Question 52: Should TPR have a 'fall back' model for cases when the modelling provided by superfunds is not adequate

- If the modelling provided by a superfund is not adequate we would question why they would be allowed to trade.

Question 54: Should the corporate entity and pension scheme have to disclose their strategic asset allocation and investment risk limits so that TPR can effectively supervise the investment strategy?

- There needs to be some oversight over both the scheme and the capital buffer's risk taking. For example, if funding had deteriorated and, or, the capital buffer had been eroded, you would not want superfunds taking excessive risk to try to make up for past losses.

Question 55: Should superfunds be required to regularly publish publicly available material on their financial position and operations?

- Yes, they should be as transparent as insurance companies need to be on an annual basis.

Question 57: How could we define 'significant deterioration' in relation to investment performance and funding level?

- Given the lack of a covenant with a super fund we think it is clear they should be expected to match assets and liabilities very closely. We would be surprised if any superfund that was, for example, deliberately taking interest rate or material inflation risk would attract much new business. As such, deterioration in funding should be concerning at almost any level and should have a tight boundary.

Question 58: Should TPR's executive arm have the power to unilaterally commission a skilled persons report in relation to superfunds with TPR acting as the end user?

- We see little downside to TPR having this power.

Question 59: Would an enforceable Code of Practice be sufficient to allow TPR to respond quickly and proactively to emerging market risks and supervise effectively?

- It may be, but the premise for it was proportionality as the number of superfunds will be lower. Although you are right that the PRA, for example, regulates a vast number of insurance companies, it currently only regulates eight insurers who actively participate in the buyout market for DB pension schemes. The number of superfunds considering entering the market, from what we have heard, could be larger than this.

Question 62: Should superfunds be subject to a bespoke levy to fund their ongoing regulation?

- That feels fair to us.

Question 64: Is five years a reasonable timeframe to assess a scheme's potential to reach buyout in the foreseeable future?

- Five years could be a reasonable measure, but it depends on some important estimations, such as the ability to afford, and how much, buyout costs.

- 2018 was a record year for the insurance buyout market, and a year that continues to prove that the industry, as a whole, is not very good at predicting the cost of buyout. One insurer we spoke to found that every buyout it transacted in 2018 was in surplus, meaning the scheme, without a contribution from the employer, had more than enough assets to afford buyout.

- Solvency estimates in our view are often too high and, in many cases, materially too high. One potential reason for this is they are generally just rolled forward from the last triennial valuation and therefore have not taken account of, for example, the increased transfer out from pension schemes seen in recent years.

- Artificially high solvency estimates are going to lead trustees to conclude that consolidation is the appropriate solution.

- Further, we think it needs very careful guidance on what it means to have a realistic chance of reaching buyout within 5 years. A well-funded scheme (on a technical provisions basis) with a strong sponsoring employer will likely be paying no contributions. The investment strategy will likely be materially de-risked to protect that position and, as such, with no contributions and a low return asset portfolio the scheme doesn't have a realistic chance of being funded to buyout in five years but clearly this doesn't feel like a scheme that is right for a consolidator.

Question 68: Should external covenant advice be a mandatory requirement of the superfund transaction process? In what circumstances would covenant advice not be required?

- We think there is certainly a question of proportionality. As we said in our opening statements, we believe there is a real danger the consolidator market will not help the schemes it was originally set up to do so, i.e. the small ones. Making the process overly complex and expensive, whilst clearly providing additional security, may preclude small schemes from getting pricing that is attractive.

- This is almost certainly the case in the insurance market at present. If that is not avoided, then the vast majority (by number rather than liability) of schemes in the UK will find themselves unable to get insurance or consolidator solutions.

- So in many cases we can see that the advice of an experienced covenant adviser will be necessary in order for trustees to make an effective decision but we don't think this will be right in every case and certainly the level of detail of such covenant advice needs to be proportionate.

Question 69: Should it be a requirement for those providing covenant advice to be regulated by either the Financial Conduct Authority or the Financial Reporting Council?

- Covenant advisers are playing an increasingly important role in the advice trustees need to consider. There clearly ought to be some professional governance of that.

Question 71: Should TPR decide whether each scheme transfer to a superfund can proceed or only have the power to prevent a scheme entering a superfund if they judge that the principles set out in the gateways are not being met.

- If the regulatory regime is set up correctly then there will be no need for TPR to decide on each case, just as the PRA does not decide for insurers. In any case that is unlikely to be effective. Often on insurance buyouts the commercial aspects of a transaction can move about materially due to how scheme assets are moving compared to the insurers pricing basis. We would expect the same to be true to some extent with consolidators, and as such you need to avoid introducing processes which could hold up transactions, such as a log jam sitting with the TPR awaiting approval.

Question 72: What checks should TPR do on a proportionate and objective basis to satisfy itself a transfer to a superfund is likely to be in the best interests of members

- The Trustees of the scheme should be justifying this and be accountable. Clearly, they will base their decision on a range of professional advice.

Our contact details

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